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## Plenary 2

## Market Stability

*9. The Rôle of Financial Regulators in Promoting Financial Stability, Speech by Mr. Howard Davies*

*Chairman of the Financial Services Authority,*
*United Kingdom*

*27 June 2001*

*Panel Two*
*Mr. Howard Davies*

# The Rôle of Financial Regulators in Promoting Financial Stability

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Chairman, Financial Services Authority

I very much welcome Claes Norgren' s decision to include a seminar on market stability on the first day of our conference this year .It is, as I hope to prove, a timely initiative.

For the FSA, as a single integrated regulator of the whole of the British financial sector, financial stability is our natural habitat. When we were set up, in 1997, we inherited 450 banking supervisors from the Bank of England, who talked of little else. Many securities supervisors with close experience of the wholesale end of the market shared their interests and concerns. And the first formal document we published was a Memorandum of Understanding between the Bank of England, the Treasury and the FSA explaining how threats to financial stability would be dealt with in future.

That MOU described the respective roles of the three organisations. Roughly, the Treasury is responsible for the legislation governing financial regulation and of course for the commitment of any public money. The Bank of England has responsibility for the stability of the system as a whole, while we at the FSA are responsible for relationships with all individual financial institutions. Also, in our own legislation, we are required, as one of our four statutory objectives, to maintain confidence in the UK' s financial markets. If an institution is in difficulties, it is for the FSA first of all to make an assessment of the impact of those difficulties; and to explore the possibility of a market-led rescue, where the institution would otherwise collapse. If lender of last resort assistance is, or may be necessary, then the Bank of England comes immediately into the picture.

In order to ensure that these relationships work effectively, there is cross - membership at the top levels between the Bank and the FSA. So I am a director of the Bank of England and David Clementi, the Bank' s deputy governor for financial stability, is on the FSA Board. Perhaps most importantly, there is a Tripartite Standing Committee which meets regularly to assess any potential threat to stable markets in London, whether it arises from domestic or international developments.

When these arrangements were set up, I think it is fair to say that we initially focused attention most explicitly on the banking system, given its particular characteristics as a transformer of short-term liabilities into long-term assets, and as a transmission mechanism for shocks arising elsewhere. And there is no doubt that we need still to keep a particularly sharp eye on the hea1th of our banking market. But it has become clearer than ever over the last four years that threats to financial stability may arise elsewhere too, whether in developments in securities markets or perhaps in imba1ances and shocks in the insurance industry. Indeed the agenda of our Tripartite Standing Committee has evolved during the period to take account of these other risks.

The agenda has evolved, too, as we have come to grips with the inter-connectedness of global financial markets. So we have been prepared to spend as much time on developments in the

Japanese banking system, or indeed life insurance industry, in the financial systems of Turkey and Argentina, or the restructuring of Asian financial markets post crisis, as we have on our more narrowly domestic concerns. This reflects the ba1ance of risks as we perceive them. With a benign macro- economic environment in the UK and a generally healthy and profitable financial sector, we have seen the main threats as coming from overseas. Of course that could change in the future.

We have reflected these changing concerns in our own institutional structure. Recently, we have created an Internationa1 Policy Committee to ensure that we give appropriate weight to internationa1 issues, and have established a single risk assessment division, operating across the whole of the Authority, looking for trouble, so to speak, in all the markets and sectors which we oversee. We have done that because we are increasingly conscious of the potentia1 for contagion between one sector and another, as well as between one country and another.

We want to ensure that we assess threats to market stability which could stem from risks within any of our regulated firms, or from changes in the external environment. It is not just financial failure that can threaten market confidence. Widespread market misconduct can be just as serious. So too can financial crime - either because its form is so serious, or so widespread within the system.

So the original concerns about financial stability held by a core group of our supervisors have now spread across the whole Authority with, I believe, generally positive consequences. It means that we are able to operate a genuinely risk-based approach to our regulatory task, focusing attention on those areas which have the greatest potential to damage the interests of savers and investors.

Of course not all securities supervisory authorities are now nested in single integrated regulators, though it is in Sweden, where we speak. The number who are part of cross-sectoral regulators continues to grow, and we held our third integrated regulators conference in Oslo last week. But in most countries the securities regulator is still a separate entity. I believe, however, that even where that is the case, the change in focus I have described, and the greater emphasis on financial stability issues, is nonetheless beginning to be identifiable.

I recognize that this observation is not uncontroversial. There are those who still maintain that a securities regulator should focus attention only on the quality of information provided in the marketplace by market participants, and should not consider the impact of collapses in securities f1rms, indeed should positively resist being dragged into prudential concerns. It is argued that securities regulators should make a virtue of their micro-focus, policing market information and market signals, in a single-minded way.

That is not my view, and I think it is evident that securities regulators are, whether they like it or not, being pushed into a broader role. For my part, I would not wish to resist this pressure, since I see no inconsistency between consumer protection, in the conduct of business sense, and the maintenance of financial stability through the promotion of orderly markets.

As past and present cases show, consumers are often the first victims of market failures or financial instability. We have only to look at the fall-out from the bursting of last year' s internet stocks bubble. Our prudential regulators are fully aware of the effect of an insolvency in an insurance firm on policyholders or investors. If they were not in the past, they will be in the future, since our insurance division, is as of April, now responsible for both prudential and conduct of 1business regulation.

We have found at the FSA that the ultimate objectives of those who used to be prudential supervisors, and those who previously described themselves as market regulators, are entirely consistent, and it has been possible comfortably to integrate their work within a single set of statutory aims.

But the most important pressures have not come from the trend towards integrated regulation. We have seen the international financial institutions, and the G7 finance ministers, pulling securities regulators more closely into discussions on the international financial architecture, and on ways of maintaining financial stability at the global level. The most visible manifestation of this pressure has come in the establishment of the Financial Stability Forum, chaired by Andrew Crockett, in which securities regulators are now full participants. The chair of the IOSCO Technical Committee sits on the Forum, as do the SEC and CONSOB, for example.

We are a1so finding that the IOSCO principles of good regulation are being used by the international financial institutions, and particularly by the IMF, as an integral part of their financial stability assessment programmes, once again recognizing explicitly the role of securities regulators in the maintenance of financial stability.

In my view this is a welcome development. But we need to recognize that it does create expectations of us in IOSCO, and creates pressure for more integrated working with other regulators internationally.

This was demonstrated vividly by the events following the collapse of Long-term Capita1 Management, the US hedge fund, at the end of 1998. That collapse, which threatened financial stability around the world, and where market melt-down was averted largely by the prompt action of the New York Fed, required a co-ordinated response by regulators internationally. Banking supervisors needed to address the question of the way in which capital and credit was provided to hedge funds, and the impact of potentially heightened risk on those providers. Securities regulators needed to address the same issues in relation to liquidity providers in their flock (as indeed did insurance regulators).

Securities regulators a1so needed to look at the market signals, and indeed at the market infrastructure which allowed Long Term Capital to take such highly leveraged positions, yet which a1so made the unwinding of those positions extremely complex and destabilizing. There were important issues of netting and documentation to address, in which securities regulators are centrally involved.

The Financial Stability Forum, which was under construction at the time, was able to contribute helpfully to the co-ordination of these various initiatives. In particular, the Financia1 Stability Forum stimulated some joint working by the Basel Committee and IOSCO' s Technical Committee, to monitor the implementation of best practices in hedge fund exposure management.

And there are other many areas in which different types of regulators need to work together. Some of them are current1y being taken forward by working groups under the auspices of the Joint Forum, which is looking at good practice in risk management across sectors, for example, and the consistency and compatibility of the different codes of good practice and the principles of good regulation promulgated by the three main sectora1 groupings. This is potentia1 useful work, though some greater impetus wil1 be required, if we want to see practica1 changes made as a result of this work, impetus which will probably have to be provided by the Financial Stability Forum.

All this means that the days when IOSCO could work in isolation are over. We need always to keep an eye open for the interactions between our work and that of other international bodies and groupings of regulators. We need to organize ourselves to make a more effective contribution to the work of the International Financial Institutions and the FSF. And we need constantly to think about the way in which our work can contribute to financial stability worldwide. I hope that today's debate will give us some useful pointers for the future.